

Office of Chief Counsel  
Internal Revenue Service

**memorandum**

CC:LM:FSH:MAN:2:TL-N-6032-00

PLDarcy

date:

to: Territory Manager, Communications, Technology & Media (Boston)  
Attn: David Levenson

from: Area Counsel (Financial Services & Healthcare) (Area 1 - Manhattan)

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subject:

[REDACTED]  
Taxable Year Ended [REDACTED]  
U.I.L. No. 0041.55-09

EARLIEST STATUTE OF LIMITATIONS EXPIRES: [REDACTED]

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This memorandum responds to your request for advice concerning the Section 41 credit computation of [REDACTED] subsequent to [REDACTED]'s acquisition of [REDACTED] percent of the outstanding shares of [REDACTED]. The advice rendered in this memorandum is conditioned on the accuracy of the facts presented to us. This advice is subject to National Office review. We will contact you within two weeks of the date of this memorandum to discuss the National Office's comments, if any, about this advice.

**ISSUE**

1. Whether [REDACTED] must include [REDACTED] percent of [REDACTED] pre-acquisition qualified research expenses and gross receipts when computing its base amount pursuant to Sections 41(c)(1)(B) and 41(c)(3)(A) subsequent to [REDACTED]'s acquisition of [REDACTED] percent of the outstanding shares of [REDACTED].

### CONCLUSION

██████ must include ██████ percent of ██████'s pre-acquisition qualified research expenses and gross receipts when computing its base amount pursuant to Sections 41(c)(1)(B) and 41(c)(3)(A).

### FACTS

The Examination Division is currently auditing the taxable year ended ██████ of ██████. For all relevant periods, ██████'s taxable year has ended on ██████. On ██████, ██████ acquired ██████ percent of the outstanding stock of ██████. On ██████, ██████ merged into ██████ pursuant to a statutory merger. Subsequent to the acquisition and merger, ██████ filed a final short taxable year return for the period beginning on ██████ and ending on ██████.

The audit team has recently commenced the audit of ██████'s Section 41 credit for increasing research activities and has expressed concern on how ██████ computed its base amount pursuant to Sections 41(c)(1)(B) and 41(c)(3)(A). First, ██████ did not include all ██████'s base-period qualified research expenses ("QREs") and gross receipts. Instead, ██████ only included a fraction of ██████'s base-period QREs and gross receipts equal to ██████ of ██████'s base period QREs and gross receipts (the number of days ██████ owned ██████ over the number of days during the taxable year ended ██████). Additionally, ██████ only included a prorated fraction equal to ██████ of ██████'s four prior years average gross receipts pursuant to Section 41(c)(1)(B).

### DISCUSSION

Section 41 allows taxpayers a credit against tax for increasing research activities. Generally, the credit is an incremental credit equal to the sum of 20 percent of the excess (if any) of the taxpayer's QREs for the taxable year over the base amount, and 20 percent of the taxpayer's basic research payments determined under Section 41(e)(1)(A)<sup>1</sup>. For tax years beginning after December 31, 1989, the base amount is computed by multiplying the taxpayer's fixed-base percentage by its average annual gross receipts for the preceding four years. I.R.C. §

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<sup>1</sup> Under Section 41(c)(2), however, the minimum base amount is 50 percent of the credit year qualified research expenses.

41(c)(1). In general, a taxpayer's fixed-base percentage is the percentage which the aggregate QREs of the taxpayer for taxable years beginning after December 31, 1983, and before January 1, 1989, is of the aggregate gross receipts of the taxpayer for such taxable years. I.R.C. § 41(c)(3)(A).

Section 41(f)(3)(A) includes special rules for computation of the credit where there is a change in ownership of a business after December 31, 1983. Section 41(f)(3)(A) provides that if a taxpayer acquires a trade or business of another person (hereinafter the "predecessor"), then, for purposes of applying Section 41 for any post acquisition taxable year, the taxpayer's QREs and gross receipts must be increased by the predecessor's relevant QREs and gross receipts. The taxpayer may only prorate the QREs and gross receipts of the predecessor, if the taxpayer acquires less than 100 percent of the predecessor's business (i.e., if the taxpayer acquires 50 percent of the predecessor, the taxpayer may only acquire 50 percent of the predecessor's QREs and gross receipts).

As originally enacted in 1981, the research credit contained rules for computing the research credit where a business changed hands.<sup>2</sup> The Economic Recovery Tax Act of 1981 (the 1981 Act) provided only that taxpayer had to include all pre-acquisition QREs of its predecessor when computing its Section 41 credit. The 1981 Act did not specifically address the treatment of the predecessor's pre-acquisition gross receipts. The legislative history to the 1981 Act explained that the rules for including the predecessor's QREs were intended to facilitate an accurate computation of base period expenditures and attributing research expenditures to the appropriate taxpayer. See Private Letter Ruling 200016004 (Dec. 21, 1999).

Congress revised the computation of the research credit in the Revenue Reconciliation Act of 1989 (the 1989 Act). The 1989 Act specifically provides that the taxpayer must also include the predecessor's pre-acquisition ~~the~~ gross receipts when computing its Section 41 credit. Budget Reconciliation Act of 1989, Pub. L. 101-239, § 7110(b)(2)(D)(ii). In explaining the 1989 Act revisions to the computation of the research credit, the House Report simply states that the rules relating to the aggregation

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<sup>2</sup> The research credit provisions were initially enacted by section 221 of the Economic Recovery Tax Act of 1981, 1981-2 C.B. 256, 293, as section 44F of the Code. Section 44F was redesignated as section 30 by section 471(c)(1) of the Deficit Reduction Act of 1984, 1984-3 (Vol. 1) C.B. 2, 334. Section 30 of the Code was redesignated as section 41 by section 231(d)(2) of the Tax Reform Act of 1986, 1986-3 (Vol. 1) C.B. 2, 95.

of related persons and changes in ownership are "the same as under present law, with the modification that when a business changes hands, QREs and gross receipts for periods prior to the change of ownership are treated as transferred with the trade or business which gave rise to those expenditures and receipts for purposes of recomputing a taxpayer's fixed-base percentage." H. Rep. No. 101-247, reprinted in 1989 U.S.C.C.A.N. 1906 at 2672. Although, the legislative history of the 1989 Act does not specifically address the inclusion of the predecessor's average annual gross receipts for the preceding four years, the statute itself clearly requires that a taxpayer must include all pre-acquisition gross receipts of its predecessor when computing its Section 41 credit.<sup>3</sup>

█████ acquired █████ percent of █████'s outstanding stock on █████. In calculating its Section 41(c)(1) base amount, █████ only included a fraction equal to █████ of █████'s base-period QREs, base-period gross receipts and average annual gross receipts for the preceding four years. We believe that such a proration contradicts clear language of Section 41(f)(3)(A). Thus, █████ must include █████ percent of █████'s pre-acquisition QREs and gross receipts when computing its base amount pursuant to Sections 41(c)(1)(B) and 41(c)(3)(A) for the taxable year ended █████.

If you have any questions regarding the above, please contact Paul Darcy of this office at (212) 264-5473 x256.

ROLAND BARRAL  
Area Counsel

By: \_\_\_\_\_  
PETER J. GRAZIANO  
Associate Area Counsel (LMSB)

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<sup>3</sup> Additionally, including █████ percent of the predecessor's QREs and gross receipts ~~of~~ the purposes of computing the fixed base percentage pursuant to Section 41(c)(3)(A) and prorating the average annual gross receipts of the prior 4 years pursuant Section 41(c)(1)(B) would clearly distort the Section 41 computation.